HEFA HANDBOOK

In an increasingly complex financial environment, HEFA is a resource and guide for nonprofit institutions in the Commonwealth.

HEFA

MASSACHUSETTS HEALTH AND EDUCATIONAL FACILITIES AUTHORITY

WELCOME TO HEFA

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Welcome to the Massachusetts Health and Educational Facilities Authority (HEFA) handbook. This booklet is an informal guide to the bond issuance process for Massachusetts nonprofit institutions, including colleges and universities, hospitals and other healthcare providers, cultural organizations, and community human service providers.

Structuring a bond transaction has become an increasingly complex task in recent years. The rapidly changing market, evolving regulatory framework and continuing change in the nonprofit sector have created a complicated environment for raising capital. The purpose of the HEFA handbook is to explain the debt issuance process so that a nonprofit institution's executives and board members are more knowledgeable about this undertaking. It is directed particularly at institutions that are new to the bond market or have not issued bonds in the last few years.

HEFA is committed to helping Massachusetts nonprofit institutions access the capital markets to obtain the lowest-cost capital possible. The transaction example used in this handbook - a negotiated public offering - is the most common of several types of financing HEFA can provide. Financing through tax-exempt leases, pool loans, private placements as well as competitively-bid transactions are also available. HEFA welcomes the opportunity to meet with representatives of nonprofits to discuss financial needs and objectives and the full range of financing options available.

STEPS IN THE ISSUANCE PROCESS

THE BOND ENVIRONMENT

Each borrower of tax-exempt debt must reconcile the requirements and expectations of three intersecting arenas - the municipal bond market, regulators, and competition in its field. Each of these worlds has undergone radical changes in the past few years, dramatically altering the way institutions raise capital.

Until the mid-1980s the municipal bond market was relatively stable, and nonprofit institutions typically issued straightforward, long-term, fixed rate bonds. In recent years, against a backdrop of volatile interest rates, Wall Street has developed increasingly complex financial products, such as synthetic securities or "derivatives," that create new opportunities for borrowers as well as new risks. Significant changes in federal tax and securities laws have increased the complexity of bond issuance. Finally, unprecedented changes in the competitive pressures in two major nonprofit sectors - healthcare and higher education - have created a demanding environment for the issuance of tax-exempt bonds.

Recognizing the complexity of the bond environment, HEFA interacts in each of these arenas so it can interpret them for Massachusetts borrowers. The Authority also routinely advocates on behalf of its nonprofit borrowers with regulatory agencies and the investment community.

THE MARKET

The municipal bond market is large, as evidenced by the 10,694 municipal issues brought to market in 1994. The par value of those issues was $163 billion. This was a 44% drop in par value from 1993's record level of $292 billion.

As one of the largest issuers of tax-exempt bonds in the nation, HEFA brings market presence and expertise to the table when an institution raises capital. Long-standing and well-maintained relationships with key analysts and managers at major investment banks, rating agencies, and bond insurers provide smooth access to the market for Massachusetts nonprofit borrowers. As a transaction is structured, HEFA's role is to make sure that borrowing institutions know about the availability of a range of alternative approaches to the market.

The Authority urges borrowers to exploit competition in the financial services industry. HEFA routinely solicits bids on a range of products including tax-exempt leases, refunding escrows,

investment of construction fund proceeds, float contracts, and guaranteed investment contracts for debt service reserve funds. These bidding processes exact the most competitive price and the most advantageous terms for borrowers.

HEFA keeps in touch with the buy side of the securities industry as well. In an effort to maximize the marketability and enhance the appetite for its securities, HEFA routinely interacts with portfolio managers and analysts nationwide to keep them abreast of developments in Massachusetts.

THE REGULATORY ENVIRONMENT

HEFA and its consultants have long experience in interpreting - and in helping institutions comply with - the myriad of regulatory and tax code requirements attendant to tax-exempt financing. The Securities and Exchange Commission (SEC) has federal regulatory authority over the trading of securities in capital markets and enforces anti-fraud regulations in the municipal market. The Municipal Securities Rulemaking Board (MSRB) covers the activities of brokers and dealers in municipal securities transactions. The Internal Revenue Service (IRS) imposes and/or defines restrictions on tax-exempt organizations and the use of tax-exempt bond proceeds.

Legal and regulatory requirements are subject to constant review and modification. The finance team must be fully informed about existing issues as well as anticipated changes. As the Securities and Exchange Commission, Internal Revenue Service or other regulators consider changes, HEFA lends its voice to those deliberations to shape any impact on nonprofit institutions.

HIGHER EDUCATION AND HEALTHCARE SECTORS

Healthcare and higher education are industries vital to the economy in Massachusetts. With a population base of a little more than 6 million, Massachusetts' 117 public and private colleges and universities enrolled more than 422,000 full-time students last year. The healthcare industry accounts for more than 10 percent of total employment in the Commonwealth.

Demographic changes of the last two decades have diminished the number of potential college students. Coupled with the fundamental shift of the national economy, this change has caused the academic community to adapt its curriculum, governance structure, and mission to become more competitive in the new environment.

The healthcare marketplace has evolved dramatically in the past year. Managed care has flourished in Massachusetts, now claiming 37 percent of the statewide market. Some markets, such as Worcester County, have seen penetration of more than 65 percent. Like hospitals in other mature managed care markets, local providers are reshaping themselves into integrated systems to compete for managed care contracts.

Both industries have undergone radical change in the last several years, and it is HEFA's role to keep the investment community abreast of these developments and the underlying strategic considerations. As need arises to raise capital, the investment community is well informed as to the viability of these institutions.

SELECTING THE TEAM

Once a nonprofit institution decides to go forward with an issuance, the first step is to assemble a knowledgeable team of financial and legal advisors. Team members are the key players who will work closely with the borrower and make recommendations as to the deal structure and marketing strategy - important elements of a successful transaction.

A **HEFA staff member** is assigned to every transaction and plays an important role in coordinating the activities of the finance team. The staff member is also responsible for obtaining the approval of the Authority's board for the deal through a series of presentations at various stages of the transaction. The staff monitors the process and assists the team in negotiating the terms of the transaction.

HEFA may also assign a **financial advisor (FA)** to the team. HEFA contracts directly with a financial advisory firm to ensure independent, reliable advice on all aspects of a transaction. The FA represents the interests of the Authority and the borrower and brings the team a national perspective in the structuring and pricing of bonds in the healthcare and higher education sectors.

The borrowing institution must choose a lead investment banker (often referred to as the **senior manager** or **underwriter**) who structures the transaction and markets the bonds. The senior manager and its counsel guide the team's efforts in compiling the Official Statement (OS) - the document that discloses detailed information about the structure of the bond issue and the finances and operations of the institution.

The legal team includes the bond counsel and the counsel for the senior manager and for the issuing institution. These advisors insure that the deal meets state and federal requirements for tax-exempt bonds and that the OS presents an accurate and complete picture of the institution and the transaction. This team will draft the legal documents and contracts that specify the respective obligations of the Authority, borrower and bond trustee, as well as the rights of the bondholders.

The **bond counsel** is responsible for preparing the legal documents associated with the transaction and providing legal and tax opinions. The **underwriter's counsel** and the **institution's counsel** represent the interests of their respective clients and also render certain legal opinions. All three work through the disclosure process to ensure the accuracy of all information and conduct due diligence sessions.

When it is time to go to market, the team customarily includes **co-managers** (other underwriters), whose purpose is to help increase the demand for the bonds. While co-managers do not bear primary responsibility for structuring a deal, they share in the risk of the underwriting and participate in the marketing of bonds. Co-managers provide broad market access and help to create a competitive environment in which to secure the lowest interest rates.

The **bond trustee** selected for the transaction is the custodian of certain funds and serves to protect the interests of bondholders. The trustee monitors the borrower's compliance with the loan and trust agreement (a document establishing the security for the bonds, restrictions on certain corporate activities, legal covenants and obligations with respect to the project, and payment of debt service and events of default).

Q ***How long does it take to go through the issuance process?***

A The process typically takes three to four months. The time line is determined by the borrower's needs and the complexity of the transaction; it can be lengthened or shortened accordingly.

Q ***Under what circumstances should an institution solicit bids for banking, underwriting or legal services?***

A It is essential that the borrower be comfortable with the members of the team, and many institutions rely on long-standing relationships. It is advisable, however, to examine these relationships periodically through a bid process to assure that fees are competitive. HEFA will perform an RFP process if requested.

Q ***How do borrowers select a trustee and printer?***

A At the appropriate time, HEFA staff issues an RFP for both a printer and trustee and then prepares a comparative analysis of all bids to assist the borrower's selection.

Q ***What are the costs involved in issuing bonds?***

A Issuance costs may include fees for: underwriting, bond counsel, Authority, rating agencies, trustee and its counsel, printer, and institution's counsel. Issuance costs may be financed through the bond issue; however, tax law limits the amount that can be financed at 2 percent of net proceeds. Costs in excess of that 2 percent must be paid as an equity contribution on the part of the borrower.

STRUCTURING THE TRANSACTION

Structuring a bond issue is an analytic and strategic undertaking. While the team assesses the institution's competitive status in the marketplace, it also considers the structural elements of the transaction that will impact the market's receptivity to the offering. The first task is to examine the needs of the institution and define the scope of the projects to be financed.

Bond proceeds are used to finance a variety of construction, renovation and equipment-related activities. Soft costs associated with construction, such as architectural work and permitting, may be financed in addition to equipment and furnishing expenditures. Bond proceeds, however, are not used solely for new projects. Nonprofit institutions may consider refinancing existing debt with bond proceeds. In addition, if an institution has used internal funds for capital projects, it may, within certain limits, use bond proceeds to reimburse those funds and amortize the cost of those projects over a longer term. Bond proceeds are also used to finance the issuance cost: underwriting, legal, trustee, printing and other fees. The finance team's role is to make certain that the use of bond proceeds and amortization of debt comport with all relevant tax law. Once the scope of the project is defined, the team considers the actual structure of the deal and negotiates a variety of covenants and security provisions.

COVENANTS AND SECURITY PROVISIONS

Bond issues include covenants or obligations that cover a wide variety of commitments by the borrower that, for the most part, protect the interests of the bondholders. As the transaction is structured, the finance team develops covenants, taking into consideration the interests of the bondholders, market, rating agencies, and credit enhancers, as well as the needs of the institution. The institution must fully understand any covenants that are proposed, because they can impact future transactions, such as mergers, acquisitions or raising additional capital.

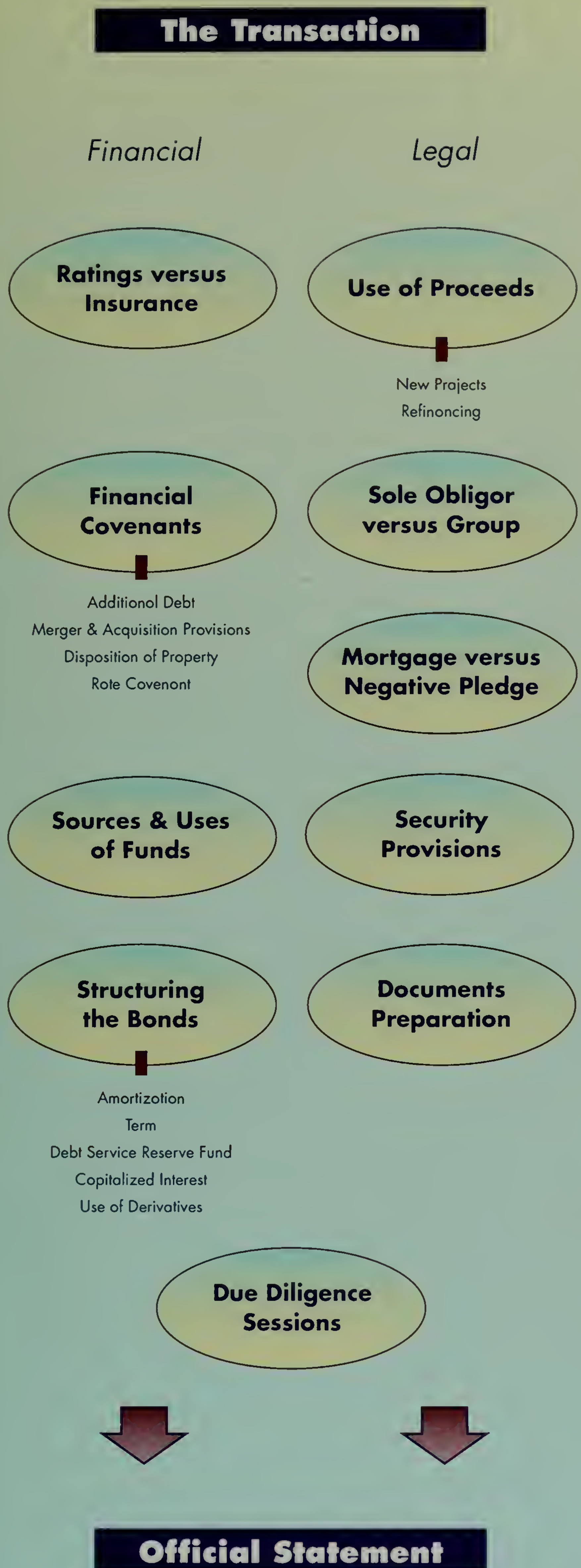
Common financial covenants include an **additional bonds test** (to allow an institution to issue additional debt on a parity with the current issue); and a **rate covenant** (specifying a minimum ratio of annual revenues to debt service). Security provisions commonly include a **debt service reserve fund** (funded at a level of one year's maximum debt service); a **pledge of gross receipts**; and a **mortgage** or **negative pledge** on real estate.

CREDIT RATINGS AND BOND INSURANCE

Having fashioned the structural elements, the team then considers whether the deal will be rated by a national credit rating agency or if the institution should seek a form of credit enhancement such as bond insurance. This is a predominantly financial decision for the borrower.

Municipal bonds may carry **credit ratings** from one or more of three agencies: Moody's Investors Service, Standard & Poor's Ratings Group, and Fitch Investors Service, Inc. The market generally likes to see bond issues which carry two ratings. The ratings process is fairly straightforward: a package of information is provided to rating analysts, and presentations are scheduled, usually at the institution.

Senior management, trustees, and key personnel are involved in the rating presentation. The HEFA staff and the team ensure that the presentations are well organized and productive by meeting with presenters in advance. During these meetings, the team offers advice on how to present institutional successes, address any weak points, and provide a clear, consistent picture of the institution. After the presentations are made, each rating agency completes its credit analysis and informs the team and the borrower of the result.



Q ***What factors are considered by the rating agencies?***

A A few of the many factors include: depth of management's experience and knowledge; historical and prospective financial and utilization/demand information; organizational strategy for the future; enrollment and SAT scores; strength of the board; composition and credentials of staff; and the institution's standing.

Q ***How can interest payments be covered during construction when the project is not yet producing revenue?***

A Through capitalized interest a portion of the bond proceeds can be used to pay the interest for a specified period of time.

Q ***Can an institution be reimbursed for capital expenditures for the previous year?***

A Yes, but the reimbursement of prior capital expenditures is subject to various tax regulations; for example, the institution's Board must approve or record its intentions to be reimbursed out of bond proceeds.

Q ***How does a debt refinancing work?***

A In an advance refunding, the borrower issues new bonds and escrows a sufficient amount to meet debt service obligations to the existing bondholders until the call date. The borrower pays debt service only on the refunding bonds.

Q ***How many times can debt be refinanced?***

A Tax-exempt bonds issued after the passage of the 1986 tax law may be advance refunded only once. There are no limits as to the number of current refundings (i.e., where the old bonds can be called immediately).

A municipal **bond insurance** policy is a guarantee designed to protect the bondholder from nonpayment of principal and interest payments on the part of the institution. The insurer receives an up-front premium for the guarantee, which may be financed and amortized over the life of the bonds. When bonds are backed by an insurers' guarantee, they sell based on the AAA credit rating of the bond insurer. The higher credit rating generally results in lower interest cost for the borrower. The team usually attempts to reduce the cost of insuring a bond issue by soliciting bids from a variety of insurers. While not every bond issue will attract bids, if there is a reasonable expectation of insurer interest, the finance team sends a packet of information to several companies. Active negotiations regarding premium and covenants ensue. Approximately 45% of the bonds issued through HEFA in fiscal year 1994 were insured.

Once the rating agencies have completed the analyses and the insurance bids are in, the team assesses the results. The finance team analyzes the difference between current market interest rates based on an AAA rating (and the cost of the insurance premium) versus interest rates based on the underlying credit rating of the borrower. While the option that carries the lowest overall cost is generally selected, this is not always the case. If an insurer requires covenants that are overly restrictive, the borrower may opt to decline credit enhancement and pay a higher interest rate to avoid these restrictions.

DERIVATIVE PRODUCTS

Recently, Wall Street's major investment banks have been prolific in the creation of new products known as **derivatives** for the municipal bond market. Derivatives or synthetic securities have been available in the corporate market for more than a decade. They are complex financial instruments whose value is based on an underlying asset such as a bond or currency. Derivatives can offer significant benefits to an institution, such as lower interest costs and/or greater flexibility, but they are not without risk.

Several Massachusetts nonprofits have used derivatives such as **inverse floaters**, **interest rate swaps**, and other innovative products that can enable an institution to achieve lower rates and substantial savings. These structures can create securities that at times can be sold at a lower interest rate than standard fixed-rate bonds.

The decision to use derivative products is based on the economic benefits to the borrower, the incremental risk, and compatibility with governing documents. HEFA staff and financial advisors are well versed in the advantages and disadvantages of derivatives. With the expertise of the financial team, borrowers are enabled to make informed judgments on the compatability of a particular derivative product with achieving their financial goals.

THE IMPACT OF MARKET FORCES

The structure of the transaction responds to the needs of the institution and the scope of the project, but it must respond to financial market forces as well. Market trends will affect interest rates and choices about variable versus fixed rates or using derivatives. Economists generally agree that as economic activity picks up, demand for capital increases and interest rates rise. The tax-exempt market, where nonprofit institutions raise funds, competes with other capital markets for a limited supply of capital.

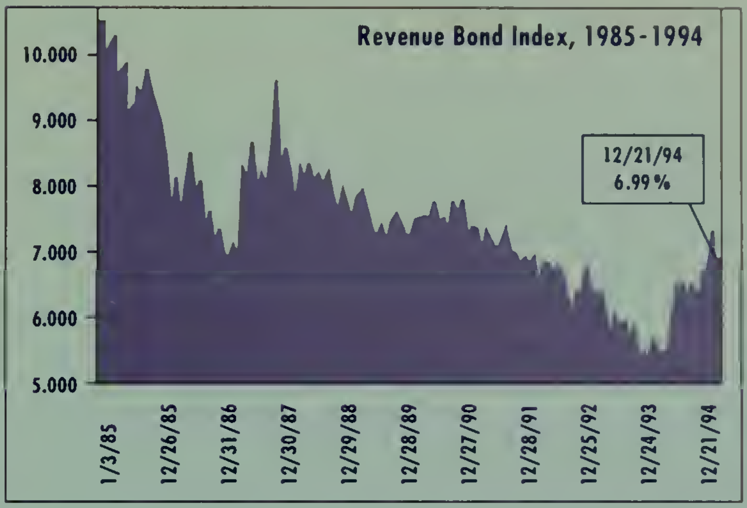
Investors in tax-exempt securities use certain benchmarks to measure market forces. The Revenue Bond Index, compiled by *The Bond Buyer*, depicts the interest rates on the 30-year maturity of 25 tax-exempt bond issues. The ratings on the 25 bonds included in the index range from Moody's Aaa to Baa-1, and from Standard & Poor's AAA to A. The ratings for the index are generally considered to be in the A to AA/Aa rated range.

The Revenue Bond Index shows that yields on tax-exempt bonds decreased steadily during a recession that began early in 1988 and bottomed out in late 1993 and early 1994. As economic activity increased, interest rates increased rather steeply to levels not seen since 1990.

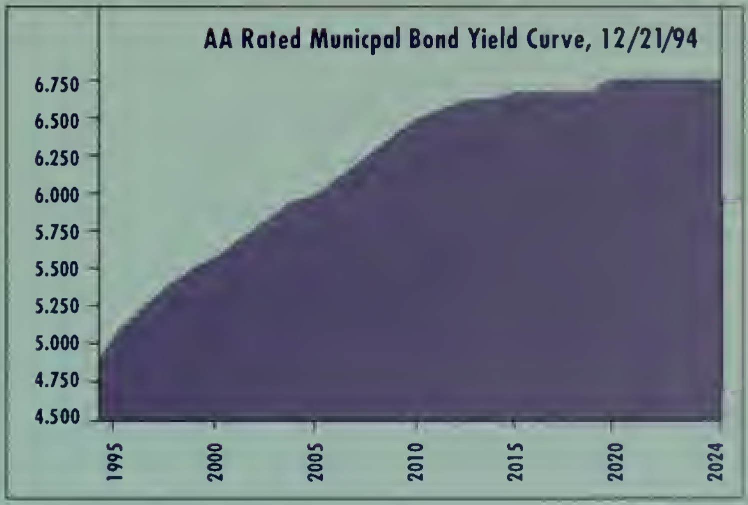
THE YIELD CURVE

The relationship between yield and maturity among bonds of similar risk but of different maturities is illustrated below in what is known as a yield curve. The yield curve is for the most recent date shown on the Revenue Bond Index above. The interest rates in the yield curve chart show the representative rates associated with varying maturities of AA rated debt. The yield curve for December 21, 1994 is steepest in the one-year to five-year range, and bonds maturing in from 20 years to 30 years from now bear very similar rates of interest. The shape of the yield curve varies over time. Generally it is an upward slope but it may be flat or even inverted in response to changing economic conditions.

The Revenue Bond Index



The Yield Curve



PREPARING THE OFFICIAL STATEMENT

While the structure of the bond offering is being discussed, the team gathers information about the institution that will serve as the basis for the **Official Statement (OS)** and other documents. The OS is the public offering document that discloses relevant information about the bonds, the borrower, the issuer, the purpose of the borrowing, potential risks, and any other information that would be important to a potential bondholder. It describes the contracts between the bond trustee (on behalf of the bondholders) and the borrower. In essence, the OS is a description of the transaction and the institution.

A **preliminary offering statement (POS)** or "red herring" is printed prior to the sale of the bonds containing all market-relevant information except the final pricing information and interest rates.

The cover page of an Official Statement gives a summary of the probable terms and features of the securities, including, for example: par amount of the bonds; maturities; issuer; dates of the obligations; interest payment dates; denomination being offered; brief statement of the security or other sources of payment; insurance, if any; tax status of the bonds; and certain members of the finance team. It also alerts the bondholder to mandatory, optional and extraordinary redemption or prepayment features and put, call or tender features contained inside the OS.

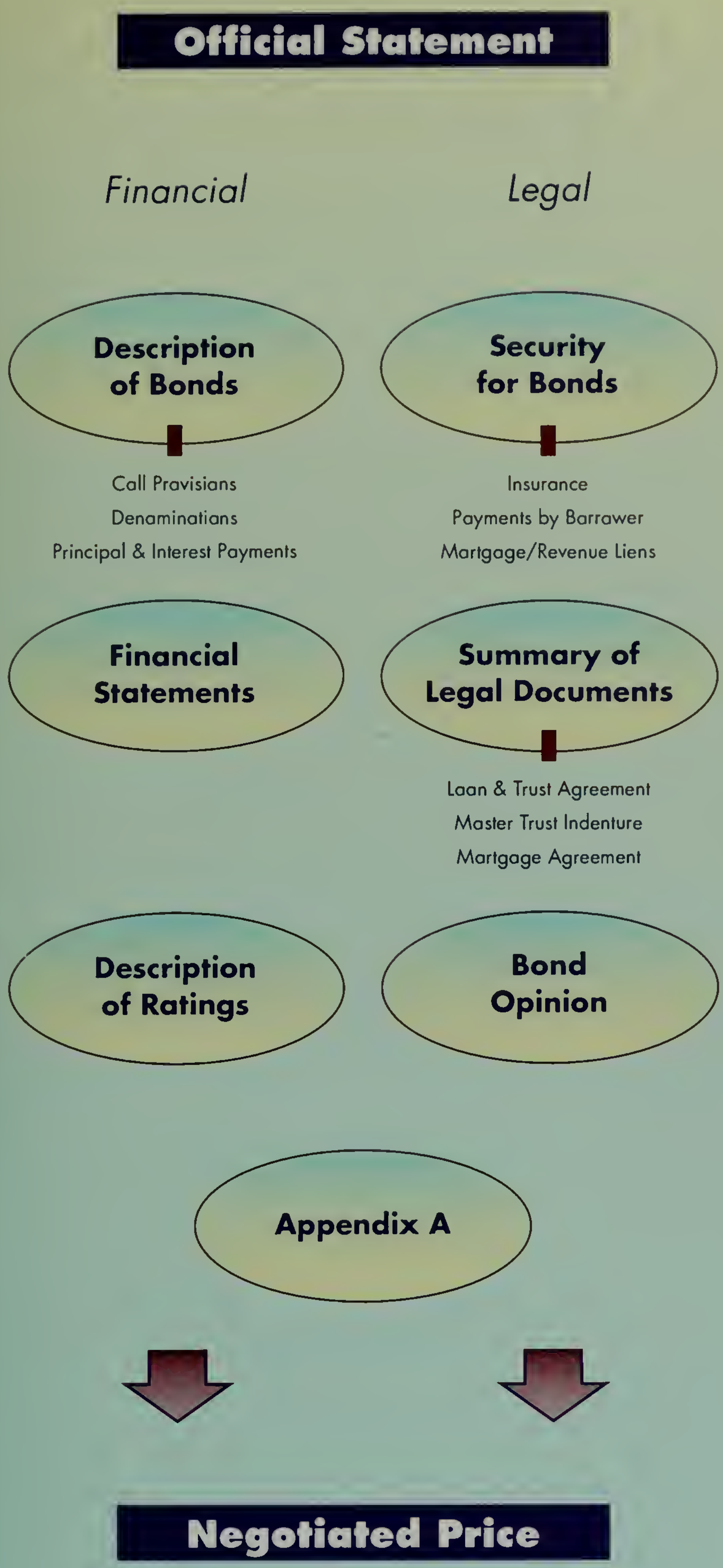
The first section of the OS contains summaries of many of the structural aspects of the issue, including: sources of payment and security for the bonds; description of bondholders' risks; insurance or ratings information; and a debt service schedule. This section may also summarize various covenants regarding additional indebtedness, rate covenant, and a description of the mortgage if applicable. The Authority is described in this section as well as matters relating to underwriting and tax exemption.

The **Appendix A** of the OS is an important – and perhaps the most time-consuming – document for an institution to compile. Appendix A discloses the story of the institution: its history, services offered, financial and operating performance, market position, governance and strategic plan. The Management's Discussion section provides the borrowing institution an opportunity to editorialize, place its performance in context and discuss strategic issues. Federal securities laws dictate that Appendix A provide a true, accurate and complete picture of the institution.

A **feasibility study** is sometimes performed to assess the institution's ability to repay the debt. The feasibility study, which is conducted by an independent firm to ensure objectivity, can also be useful when it is time to market the bonds.

Certain documents set forth the borrower's legal obligations. The **trust agreement** describes the covenants, financial and debt service obligations, mortgage or other security of the borrower as well as those duties and responsibilities of other parties to the bond issue, including HEFA and the trustee. A **master trust indenture**, sometimes used in healthcare transactions, contains covenants and security, but unlike a conventional trust indenture this document often describes an **obligated group structure**, which allows an institution to issue debt based upon the combined credit of several corporate entities of the non-profit institution. These and other legal documents, the **bond counsel's opinion**, and **audited financial statements**, are summarized or included in appendices in the OS.

Just before selling the bonds, the team conducts a formal **due diligence** session with the senior management and board members of the institution and its auditors, to ensure that all information in the OS is correct and that no information is omitted.



Q ***What is the Official Statement?***

A The OS is the offering document. It is the composite description of all the documents pertaining to the issue: it contains the borrower's presentation to the market and the bondholders' security.

Q ***What is the bond counsel opinion?***

A An essential document in a bond issue, the bond opinion affirms that (1) the bonds are legal and binding obligations of the issuer under state and federal law and (2) the interest on the bonds is tax-exempt under state and federal law.

Q ***What are call provisions?***

A Call provisions give the borrowers the option to retire all or a portion of the bonds before the stated maturity date at a set price, often at a premium to par. It is common to have bonds noncallable for 10 years after issuance. Typically, they will be callable at 102% of par, declining to par in year 12.

Q ***What is the purpose of a rate covenant?***

A This covenant commits the borrower to certain financial standards that give bondholders an early warning signal of potential financial problems.

Q ***What if an institution can't meet the terms of a covenant?***

A When a covenant is not met, a consultant is usually engaged to examine the institution's financial or operational procedures and to develop a plan for meeting the terms of the covenant. These requirements are explicitly spelled out in the bond documents.

NEGOTIATING A PRICE

Once the offering structure has been established, the underwriter analyzes market conditions to determine optimal timing for the issuance. The senior manager's underwriting and sales force start the sale process. The offering is listed in ***The Bond Buyer***'s calendar to announce the intended sale.

The POS is sent out prior to the sale to dealers and prospective buyers. Although the underwriter manages the final pricing negotiations, co-managers are also important at this juncture, since they can provide broader market access and increased demand for the bonds.

In a negotiated sale, the bonds are bought by the underwriters based on a pricing negotiation. The bonds are sold in turn to **institutional investors** such as banks, insurance companies and mutual funds, as well as to retail investors. The underwriter's profit is the difference between the purchase price and the reoffering price to investors. That profit is commonly referred to as the **spread**.

The sale process is initiated by the senior underwriter with a conference call involving the institution's executives, HEFA staff members and advisors to discuss market conditions, timing of the marketing and to give an indication of price. A preliminary price is negotiated for the offering which is typically comprised of **serial bonds**, which mature in consecutive early years, and **term bonds**, which have a single longer maturity date. The parties consider a preliminary pricing scale, when the bonds will be offered to the market, and the order period. Immediately after the agreement on preliminary pricing, the underwriters put the scale of interest rates and prices on a computer network or fax machine, and proceed to solicit orders. Another conference call takes place to provide feedback on the number of orders taken.

Based on the demand for bonds in each maturity HEFA may request the senior underwriter to reprice the interest rate. This would particularly be the case on any maturities where the number of orders is greater than the number of bonds available. The reverse situation may also occur. HEFA staff members are present through these negotiations to discuss the senior manager's proposals, offer alternatives, and ensure that the final price is fair.

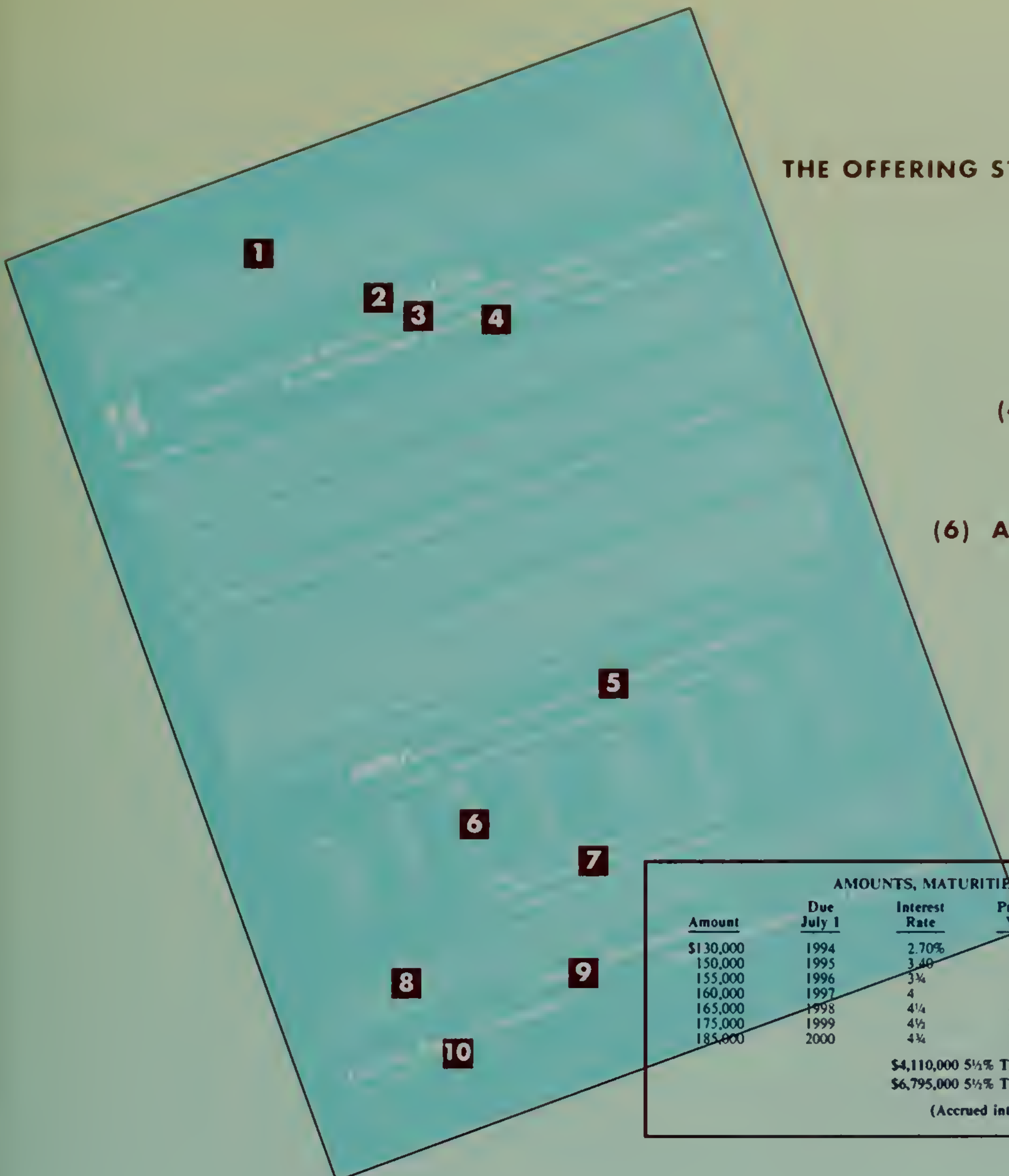
When the final price, yield, and maturity are decided the senior manager will make a verbal underwriting offer to the institution and HEFA. The verbal commitment is followed by the signing of a **bond purchase agreement** and a **good faith check** is delivered to HEFA from the underwriter.

Q *What is* The Bond Buyer*?*

A A financial newspaper, published daily in New York, covering the municipal bond market, and providing news, analysis, and data of interest to issuers, underwriters, and investors.

Q *What is a Bond Purchase Agreement?*

A An agreement between the issuer of the bonds and the underwriter setting forth the terms of the sale (e.g., price of the bonds, interest rate), the conditions to closing, any restrictions on the liability of the issuer, and indemnity provisions (if they are not covered in a separate indemnity letter).



THE OFFERING STATEMENT/ COVER PAGE:

(1) BOND OPINION

(2) AMOUNT

(3) HEFA

(4) NAME OF BORROWER

(5) INSURER (if any)

(6) AMORTIZATION SCHEDULE

(7) TERM BONDS

(8) FINANCE TEAM

(9) SENIOR MANAGER

(10) CO-MANAGERS

AMOUNTS, MATURITIES, INTEREST RATES AND PRICES OR YIELDS

Amount	Due July 1	Interest Rate	Price or Yield	Amount	Due July 1	Interest Rate	Price or Yield
$130,000	1994	2.70%	100%	$190,000	2001	4.80%	4.90%
150,000	1995	3.40	100	445,000	2002	4.90	5
155,000	1996	3¾	100	465,000	2003	5	5.10
160,000	1997	4	100	480,000	2004	5.10	5.20
165,000	1998	4¼	4.30	510,000	2005	5¼	5.30
175,000	1999	4½	4.60	535,000	2006	5.30	5.40
185,000	2000	4¾	4.80	565,000	2007	5.40	5.45

$4,110,000 5½% Term Bonds Due July 1, 2013 — Price 98½%
$6,795,000 5½% Term Bonds Due July 1, 2020 — Price 96¼%

(Accrued interest from June 15, 1993 to be added) 6

Q *What is the yield on a bond?*

A The yield is the interest rate return based on the bondholders' investment. Yields on municipal bonds are usually quoted in increments of basis points. A basis point is one one-hundredth of a percent (.01 per cent).

Q *What is the coupon?*

A The interest rate stated on the bond that is payable to the bondholder.

Q *What is the maturity date?*

A The date on which the bondholder receives the final principal and interest payment and the bonds are retired.

Q *Are there any last-minute changes involved in pricing?*

A Until the bond purchase agreement is fully executed, mid-course corrections can be made. If the bonds are under- or over-subscribed, they may be repriced at a higher or lower rate of interest.

Q *What events could affect the scheduling of a bond offering?*

A The presence of similar offerings in the market, Federal Reserve Bank forecasts or interest rate changes, and release of certain economic indicators can impact scheduling.

Q *Who buys tax-exempt bonds?*

A The bonds are usually purchased by both institutional investors, such as mutual funds, and retail or individual investors.

Q *What is HEFA's role in the sale?*

A HEFA staff and the financial advisor take an active role in the pricing and sale to advocate the borrower's interest.

Q *What is an original issue discount?*

A An original issue discount involves offering the bonds at a price slightly below par. Because such discounts are attractive to investors, they can often secure lower interest rates for the borrower.

THE CLOSING AND INVESTMENT OF PROCEEDS

A bond closing normally occurs over a two-day period about two weeks after the pricing. At the closing, bond documents are finalized and signed and funds are transferred to the appropriate parties. The trustee begins to implement the terms set forth in the trust agreement. The final OS has been printed and distributed to each purchaser, and the bonds are delivered to **The Depository Trust Company (DTC)**. Institutions need to be aware of a number of issues following a closing, including the temporary use of bond proceeds, IRS **arbitrage rebate requirements**, ongoing SEC reporting requirements, and the development of an investor relations program.

After an institution has issued its bonds, it must choose the best alternative for investing the proceeds during the construction period for its capital projects. Investment of bond proceeds is limited to certain securities under the trust agreement. Many of these options - including several developed specifically by HEFA for its nonprofit issuers - are designed to obtain a higher return.

HEFA introduced the **Short Term Asset Reserve**, or **STAR Fund**, in 1991 to provide institutions with an option for the temporary investment of bond proceeds. The STAR Fund is similar in structure to most money market funds, but it offers the additional benefits of greater liquidity, higher income, and the convenience of not having to schedule investment maturities to meet project draw schedules. The STAR Fund is professionally managed and designed to assist investors in complying with arbitrage rebate requirements.

The STAR Fund has consistently achieved a higher return than comparable funds or the IBC/Donoghue Index.

In the event of a refunding, the Authority's financial advisor customarily seeks competitive bids on the escrow to secure the best price for the purchase of the escrow. HEFA helped pioneer the practice of bidding **refunding escrows.**

New developments in the investment community have complicated even such previously mundane areas as investing debt service funds. HEFA staff can provide information on a full range of these options, including **forward rate agreements** (designed to attain yields more characteristic of longer-term investments), and interest rate swaps (enhancing yield by exchanging a fixed rate for a variable rate on a notional amount equal to the average payments in the debt services fund). Each alternative allows investing institutions the potential to maximize return on these reserves by obtaining a higher rate of interest normally associated with a long-term investment.

The initial sale of bonds is typically not the only sale of those bonds. There is a very active **secondary market** for trading municipal bonds. Bonds can change hands among investors throughout the life of the issue. While it has always been HEFA policy to encourage nonprofit institutions to maintain an ongoing investor relations program after closing a deal, recently implemented SEC regulations will require a stricter standard in the near future for disclosure in the secondary market. For example, institutions will be required to file annual financial statements with a central depository, or to publish notice of material events, such as mergers, that might affect the underlying credit of the institution and be of interest to bondholders and potential bondholders trading in the secondary market. HEFA also encourages institutions to keep insurers and rating agencies similarly informed.

Q ***What are arbitrage rebate requirements?***

A If earnings on investments acquired with the proceeds of a bond issue are greater than the allowable bond yield, the excess earnings are generally considered arbitrage profits and must be rebated to the US Treasury every five years. There are some exceptions to this rule, and borrowers should consult counsel about their specific situations.

Q ***What is a refunding escrow?***

A The refunding escrow is a portfolio of Treasury Securities that at maturity are sufficient to pay the debt service on refunded bonds prior to redemption, and to pay the full purchase price of the bonds at redemption.

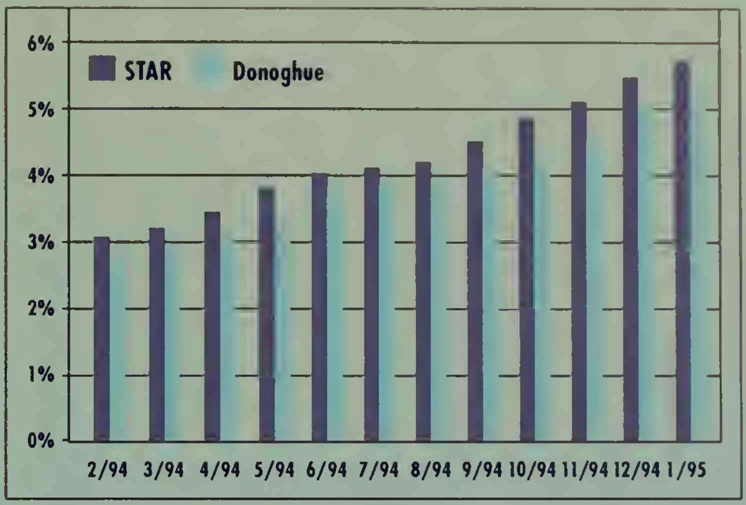
Q ***Does the borrower have to expend bond proceeds immediately?***

A While there are a number of exceptions to this rule, the IRS requires that bond proceeds used for capital projects be expended within three years or be subject to yield restriction.

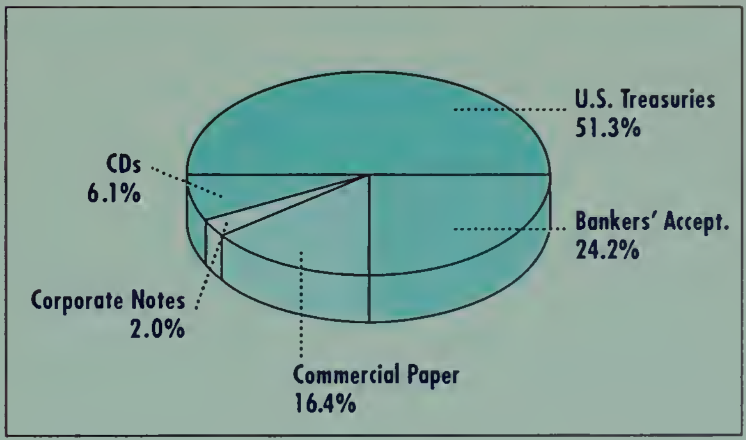
Q ***What kinds of investment options exist for bond proceeds?***

A There are numerous options for investing proceeds that can be discussed with HEFA staff. One option, developed by HEFA, is the STAR Fund, a professionally managed fund for the short-term investment of proceeds.

Monthly Returns: STAR Fund vs. IBC/Donoghue Index



Current STAR Fund Holdings by Type (1/20/95)



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** List as of June 30, 1994.*

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